Krzysztof Rybiński: Rapid credit growth in converging economies – the challenges ahead

Closing remarks by Mr Krzysztof Rybiński, Deputy President of the National Bank of Poland, at the National Bank of Poland International Conference of Central Bankers and Economic Educators "Monetary Policy Challenges Resulting from the Rapid Credit Growth in Converging Economies", Warsaw, 23 November 2007.

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Ladies and Gentlemen,

We have now come to the end of the conference on "Monetary Policy Challenges Resulting from the Rapid Credit Growth in Converging Economies", and it is my honour to provide some concluding remarks. Over the last two days, we have been discussing opportunities, challenges and problems related to the rapid credit expansion in Central and East European (hereafter: CEE) economies that find themselves in a convergence process towards more advanced EU member states. In the following, let me briefly summarize the main conclusions that emerge from all the presentations and discussions.

Before I proceed, I would like to thank you all for attending this conference, especially the speakers and discussants for their valuable contributions. Most of all, I would like to thank central bank governors from our region: Ms Júlia Király, Deputy Governor of the Magyar Nemzeti Bank, Mr Andres Sutt, Deputy Governor of the Bank of Estonia, Mr Sławomir Skrzypek, President of the National Bank of Poland, and Mr Zdeněk Tůma, Governor of the Czech National Bank, for enriching this conference with their presence and their views. Without any doubt, the distinguished economists and practitioners who have actively taken part in this conference have been its most valuable asset.

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Turning to the rapid credit growth that has been observed in CEE economies over the past years, the first question that comes to an economist's mind is the following: do these developments pose a threat to the macroeconomic stability of the countries of interest? In order to answer that question, one has to ask another: what forces have been the decisive factors behind the rapid credit expansion? Several papers presented at this conference have sought to provide answers to these questions.

One approach, followed by the papers[1] presented in the first session, has been to estimate the equilibrium rate of credit growth and check whether the actual growth has been below or above that equilibrium path. The decomposition of credit growth into a convergence and a boom component has shown that for most of the CEE economies, the former component has been dominant, i.e. the rapid credit expansion can to a large extent be attributed to a continuous improvement in the macroeconomic fundamentals and the initial low credit volume in these countries. However, there are notable differences across the region: the Baltic states (especially Latvia and Estonia) and South-East European countries (especially Croatia and Bulgaria) seem to have approached or even reached the equilibrium by 2004 or 2005, whereas in the case of the Visegrad countries (especially the Czech Republic and Poland) the credit-to-GDP ratio seemed to remain below its estimated equilibrium level at that time. Of course, it might well be that some of the CEE economies have overshot the

[1] Kiss, G., Nagy, M., Vonnák, B.: *Credit Growth in Central and Eastern Europe: Trend, Cycle or Boom?*, MNB Working Paper No. 2006/10, November 2006 and Egert, B., Backé, P., Zumer, T.: *Credit Growth in Central and Eastern Europe: New (Over)Shooting Stars?*, ECB Working Paper No. 687, October 2006.

equilibrium only recently, but one has to wait for a while until the relevant data become available before this overshooting can be captured in empirical analyses.

The general upshot of these papers is that the rapid credit expansion in CEE economies has mainly been fuelled by demand factors: the buoyant economic growth and the ensuing increases in disposable incomes, rising expectations with regard to future income prospects related to EU accession, remarkable decreases in interest rates, and falling or low and stable inflation rates. A similar message emerges from two papers presented in Session 3, which have scrutinized the factors that contributed to the very rapid credit expansion in the specific cases of Romania[2] and Lithuania[3], and from the World Bank report[4] presented in Session 6, which provides a detailed overview of the recent credit developments in all ten new EU member states from Central and Eastern Europe. While stressing the demand factors that have fuelled the expansion of credit to the private sector, these papers also point out that the supply side has played a role too: the boost in credit volume was made possible by the privatisation of banks, deregulation of financial systems, and the deepening of the financial markets in the region.

Both the above-mentioned World Bank report and the paper[5] prepared by International Monetary Fund staff, also presented in Session 6, were aimed at identifying vulnerabilities and risks that might threaten the financial stability of CEE countries. The former concludes that these countries vary rather widely with regard to the sustainability of the credit growth. While the largest new EU member states seem to be still on the safe side, the Baltic states and, to a lesser extent, the emerging economies of South-Eastern Europe probably witness a credit boom that leads to significant macroeconomic imbalances and might ultimately end in a crisis. These conclusions reinforce the findings of the papers presented in Session 1, which I have discussed before, that the Baltic states and the South-East European economies have probably already reached or even overshot the equilibrium level of credit to GDP.

The paper prepared by IMF economists, in turn, addresses the issue of sustainability by focusing on capital flows. Within a dynamic stochastic general equilibrium model, it analyses the short- and mid-term risks arising from the opening up to capital flows and alleviating of credit constraints for the case of a small converging economy. Both papers prepared by economists from international financial institutions and presented in Session 6 offer recommendations for policymakers in such economies, which can reduce vulnerabilities and risks in the face of rapid credit growth. Under such circumstances, it is crucial that macroeconomic policies do not add to the existing demand pressures – tightening fiscal policies is often a must-do – and that steps are taken to strengthen the health of the financial system. This can be achieved by tightening regulatory measures, raising prudential standards and enhancing supervisory coordination and cooperation, as well as by supporting a better understanding of financial risks by the general public, e.g. by means of public awareness campaigns.

Similar policy recommendations follow from another paper[6] prepared by IMF staff, which was presented in Session 2 and sought to identify the features that distinguish "good" credit

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[2] Neagu, F., Mărgărit, A., Copaciu, M., Racaru, I. Mircea, R., Andrassy, A.: *Non-Government Credit in Romania: Perspectives and Implications*, National Bank of Romania, Occasional Paper No. 4, June 2006.

[3] Ramanauskas, T: *Interest Rates, Credit and Macroeconomy – a Small Structural Model for the Lithuanian Case*, mimeo, November 2006.

[4] World Bank EU8+2 Regular Economic Report, Special Topic: *Credit Expansion in Emerging Europe: A Cause for Concern?*, January 2007.

[5] Bems, R., Schellekens, P.: *Finance and Convergence: What's Ahead for Emerging Europe?*, IMF Working Paper No. 07/244, November 2007.

[6] Barajas, A., Dell'Ariccia, G., Levchenko, A.: *Credit Booms: the Good, the Bad, and the Ugly*, mimeo, November 2007.

booms from "bad" ones, i.e. such that probably eventually lead to a banking crisis. The analysis has shown, *inter alia*, that better banking supervision lowers the probability of a crisis. It has also established that booms that coincide with current account imbalances seem less dangerous (a finding that may seem counter-intuitive at a first glance), that trade openness is another factor that makes a crisis less probable, and that the more prolonged booms as well as those accompanied by high inflation or slow economic growth are the "bad" ones.

Another important topic raised during the conference was housing. This is hardly surprising given that housing loans constitute the larger part of credit extended to households. Now that the world economy is trying to shrug off the consequences of the liquidity crisis of late summer and falling house prices in America, the question as to how sound housing finance in converging CEE economies really is has become substantial. A reassuring answer to that question comes out of the analysis in a paper[7] presented in Session 4, which focuses on house prices in the CEE economies. The analysis has shown that the very rapid house price increases in our region have generally been based on fundamental factors: a boost in housing demand due to rising per capita GDP, falling real interest rates and demographic factors, coupled with the rapid development of housing markets and housing finance, virtually non-existent in the era of central planning. All in all, the house price inflation in the region seems to reflect a process of relatively fast convergence to a new equilibrium.

Again, however, the question remains open whether that new equilibrium has already been reached or perhaps even overshot in some economies, and whether the rapid growth in mortgage loans that is a natural consequence of the housing boom can be safely described as sustainable. Experience has taught us that rapid credit growth cannot be ignored even if it reflects nothing more than a convergence process, as it usually means that loans have been extended to households with ever lower margins. Another paper[8] presented in Session 4 has focused on the changes in the margin of households who repay loans (the margin is defined as the difference between disposable income and basic living costs as well as debt repayment costs) for the case of Poland. Although the average margin has not declined despite the rapid credit growth in recent years, stress tests have shown that households that repay debt are rather vulnerable to adverse financial and real shocks. Specifically, economic slowdown, monetary policy tightening or financial market turbulence would each bring about a reduction in the households' average margin and cause a non-negligible percentage of households to fall into a negative margin. This would probably lead to a deterioration of banks' asset portfolio – a result that cannot be ignored by monetary policymakers and bank supervision authorities.

Another result that is of high relevance to monetary policy is the substitution effect between domestic and foreign currency denominated loans, which has been the focus of a paper9 presented in Session 2. The high percentage of foreign currency indebtedness, mostly mortgage debt, that can be observed in many CEE economies shows that domestic and foreign currency loans are treated as close substitutes in these countries. As households generally do not hedge against foreign exchange risk, their debt servicing burden rises when the home currency depreciates. Admittedly, depreciation of CEE currencies has hardly been an issue in the recent past; the currencies in the region have either stable exchange rates (when these are pegged) or tend to appreciate (when the exchange rate regime allows it). However, concerns remain that under such conditions, domestic monetary policy cannot

[7] Égert, B., Mihaljek, D.: *Determinants of House Prices in Central and Eastern Europe*, BIS Working Paper No. 236, September 2007.

[8] Zajączkowski, S., Żochowski, D.: *Housing Loans Growth, Foreign Currency Risk and Supervisory Response: the Polish Case*, mimeo, November 2007.

[9] Brzoza-Brzezina, M., Chmielewski, T., Niedźwiedziska, J.: *Substitution between Domestic and Foreign Currency Loans in Central Europe*, mimeo, November 2007.

effectively control the growth of credit due to the substitution effect: monetary tightening at home does not lead to a slowdown of total credit growth, but rather to increased foreign currency indebtedness. The analysis in the paper has identified the existence of this effect in the case of three largest CEE economies.

Generally, most papers presented and discussed over the last two days have stressed the necessity of prudential supervision of the banking system in the face of a credit boom. Even though financial deepening and capital inflows bring about long-term benefits that can hardly be overstated, in the short to medium run they can lead to imbalances and distortions that pose a threat to the macroeconomic stability of a country. We have recently seen how badly lax lending and improper credit risk management can end in developed countries. In the case of converging economies, which are generally more financially vulnerable than fully-fledged market economies, it is all the more important to closely monitor risks to the financial system, enhance cooperation between financial institutions and supervisory authorities, and impose prudential constraints on lending.

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The ideas that I have summarized so far were expressed in the papers prepared and presented by economists from academia, central banks, and international financial institutions. We have also heard important voices of top commercial bank executives and central bank governors during the panel that has just ended. Household credit, and mortgages in particular, will remain an important source of revenues and profits for commercial banks. At the same time central bankers and banking sector supervisors will likely watch credit developments very closely to make sure that best lending practices are in place.

In closing, I would again like to thank you all for attending the conference. I would like to thank the organizing committee and the NBP staff for their excellent work. I hope to meet you again at another conference organized by the National Bank of Poland.

Thank you.